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Bargaining with Giants: why is there no dialogue with China over iron ore?

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Abstract

The attempt to create a stable diplomatic triangle out of relations between brothers number one, two and twelve is a fraught enterprise, and most particularly so when hard security issues are front and centre. On the other hand, Australia and China arrive at the market for iron ore from different sides but with a measure of substantive equality as number one exporter and number one importer. Since trade in industrial raw materials has always provided a mechanism for the manipulation of strategic vulnerabilities in East Asia, the commencement of a dialogue over the terms and conditions of iron ore trade would have broader strategic as well as narrower economic purposes. Now that the China boom is slowing, prudential interests in market stabilization converge with the higher normative pursuit of market civilization behind this dialogue.

‘We do not know what is happening to us, and that is precisely the thing that is happening to us – the fact of not knowing what is happening to us.’

José Ortega y Gasset, *Man and Crisis*, tr. M. Adams, George Allen & Unwin, London, 1958, p. 119.

In 2008, Kevin Rudd went to Beijing proclaiming himself a friend – the sort of friend able to speak truthfully about issues his audience wouldn’t necessarily want to hear. He was absolutely correct; China’s leaders didn’t want to hear what he proceeded to tell them. He wasn’t invited back. He’d forgotten a basic diplomatic protocol – that the important role of *consigliere* is filled by invitation rather than self-nomination. Abbott’s northern expedition of recent times sporting new Coalition principles for foreign investment policy suggests that nothing much has been learned across the bench.

Australian politicians rarely make anything like these kinds of mistakes when visiting the US; almost without exception, they swerve to the opposite extreme. Consider Julia Gillard, who went to Washington needing to prove she was no left-

faction ideologue. She touched down at a time when the locals were deadlocked over the trade-off between growth and debt as the way out of the Global Financial Crisis. A self-confessed novice, Gillard chose to remind everyone about the America of her youth, the country that could do anything, even put a man on the moon. It was a romantic recollection of the state of the union in 1969, perfectly understandable for an under-ten, and perhaps even in the adult who grew out of childhood giving undivided attention to something completely different. But 1969 was a year where there was much else that demanded remembrance – not least, on the budgetary front, where America could no longer do anything, where trade-offs between guns and butter finally needed to be made. Now there was a remembrance with lashings of contemporary relevance! However, if you decide to whisper sweet nothings in Washington's collective ear – Abbott's 'family-talk' of a few months back furnishes another example – then at least you're likely to get invited back.

There are more serious ways, no doubt, to illustrate the profound policy dilemmas posed by the triangulation of Australia's position between the US and China. At the most general level, an inflection of Ortega's meditation on uncertainty captures Canberra's present conundrum: 'Nothing (including war, thankfully) is inevitable. Because nothing is inevitable, then anything goes. And when anything goes, then nothing becomes policy'. Enough said. We must stop it before we go mad. And stopping it, as Ortega would have gone on to say, requires perspective. Along two fronts.

On the first front, we need perspective on the nature of Canberra's triangulation. Most triangle talk harks back to the Nixon-Kissinger strategy where the US situated itself between the two conflicting giants of the communist world and was made relatively more powerful because it enjoyed better relations with each of them than they did with each other.¹ Compared to that great power triangle, the most significant thing about the US-China-Australia triangle is that it is radically unbalanced. Number one, number two and number twelve makes for an isosceles

¹ For the industry standard work on the subject, see Robert S. Litwak, *Détente and the Nixon Doctrine: American Foreign Policy and the Pursuit of Stability, 1969-1976*, Cambridge University Press, Cambridge, 1984. For a potentially more relevant but neglected treatment of other triangles, see Min Chen, *The Strategic Triangle and Regional Conflicts: Lessons from the Indochina Wars*, Lynne Rienner, Boulder, 1992.

triangle, an unstable structure that always threatens to fall over when made to stand on its shortest side. Such a triangle is least robust when addressing those issues where numbers one and two have real strengths compared to number twelve. Like hard security.

Hard security issues do present a field of policy choices for Australian governments, but none of those field positions gets around the basic problem of asymmetry. Because triangular thinking locates Australian governments in the company of big league players, it encourages them to think big – the first step down the road to what Kim Beazley once called (perhaps unfortunately) ‘self-hardening’. Almost immediately, the attempt to walk with giants, let alone rip an arm or two, exposes a credibility problem that is both economic and technological. Faced with precisely this blend of expensive issues in 2009, the ‘genius’ of the Rudd government was to conscript the Keynesian deficit into service as a military force multiplier. Like other bastard military Keynesians, Defence forgot that the good Keynesians of Treasury would flip over to contractionary settings once the economy was deemed to be recovering – not a recommended turn for a military attempting to gaze over a two-decade time horizon. The results are spread all over the front pages the recent press. Self-hardening turned out to be so much policy wonk (a highly technical term, most easily appreciated when uttered with an Auckland accent).

The standing alternative is to play a different kind of hard security game at a more regional level. Ever since Paul Dibb recommended removing the F-111 from service in 1986, the question about the need for a deep strike platform in one or another format has provided the most obvious fork pointing down the low road. It is a road kept alive most recently by Mark Thomson² (who was, most pertinently, the one and only economically literate advisor on the 2009 Defence White Paper team, the one who appeared to walk away from the whole process when everything was put on tick). Nonetheless, the danger with the low road has always been that ‘self-reliance within alliance’ will become a formula for bigger and better ramp ceremonies, especially now that ‘the pivot’ threatens to invert it into ‘alliance within self-reliance’.

² Mark Thomson, ‘We needn’t worry about defence cuts’, *Australian Financial Review*, 16 August 2012, and also ‘We need defence we can afford’, *The Australian*, 18 September 2012.

A modicum of perspective on the hard security aspects of the isosceles triangle suggests, therefore, that no real exit will be found. That will only come when Australian governments begin talking to issues where they have substantive strength rather than weakness on their side. And there is one and only one issue area where Australia enjoys the right to equal standing in the company of brothers number one and two – as a commodity trader, especially in bulk commodities such as iron ore and coal, the raw materials that underpin China's industrial growth.

Inside Canberra's parliamentary triangle, the social valuation of Australia's position in bulk commodity markets appears to have changed quite fundamentally during the last decade or so. At the end of the Asian Financial Crisis, commodity prices, led downwards by oil, stood at record lows for the whole of the post-war period – for iron ore and steaming coal, two and three US cents per kilogram respectively.³ Bulk commodities were axiomatically regarded as part of the 'old' economy, a source of considerable embarrassment to a government intensely attracted to the 'new' economy of high tech and high finance. Within a few years, however, even the leader of this cheer squad for the latest American capitalist model could be found trumpeting Australia's potential to become 'an energy superpower'.⁴ And not much later, a Labor government would be celebrating the role that commodities played in helping Australia avoid recession during the Global Financial Crisis, and looking for policies that would help spread and prolong the commodities boom that had, seemingly against all odds, unfolded in the meantime.

But some things remain very much the same. In particular, throughout the boom and into the bust, Canberra has remained wedded to an absolutely minimalist definition of its own role as a regulatory state where most things that happen in extractive industry are the prerogative of commercial actors. There are, of course, exceptions – foreign investment, taxation, environmental approval and (occasionally)

³ Marian Radetzki, *A Handbook to Primary Commodities in the Global Economy*, Cambridge University Press, Cambridge, 2008, Table 1.2, p. 11.

⁴ See, in particular, John Howard, 'Address to the Committee for Economic Development of Australia', Sydney Convention and Exhibition Centre, Sydney, 18 July 2006. Howard was, of course, largely captivated at that particular moment by the economic benefits that might conceivably flow from a local uranium enrichment industry, an option he thought he had carved out from Bush's GNEP. He ignored entirely the less glamorous argument that existing exports of thermal coal, LNG and uranium already did make Australia an energy superpower, albeit of a very unusual kind.

competition policy – but these largely weigh upon preliminaries; in particular, upon the lodgement of any particular firm within the sector. And no one in Canberra is so silly as to talk about free markets, since the high level of concentration in extractive industry usually makes a mockery of the idea. Nonetheless, once entry rights have been obtained, governments of both persuasions follow a pathway that gives maximum freedom of action to boardroom decisions.

East Asian realities have, however, always been considerably different: in this region, the products of extractive industry arrive at market with high concentrations of strategic content as by-product. And there are no multilateral rules of the game capable of separating out those strategic effects. The proposition that a maximum of corporate freedom will achieve that separation is a delusion made all the more beguiling because it emanates from a country with a long suite of natural resource endowments – endowments that, in recent times, predominantly end up in China, the pointy end of Canberra's strategic triangle. What, one is compelled to ask, is the logic behind enthusiastic self-emasculation?

The regional story

The economic and strategic histories of East Asia and Australia's relationship with it should be telling us very different stories. It is a region that, most especially along its rimlands, has never been well endowed with the basic raw materials of the second industrial revolution – oil, iron ore, alumina. East Asian states nonetheless intent upon industrialization therefore have little alternative but to import them. And the more they succeed in growing their industrial base, then the greater will be the volume of these imports. The resultant problem is that high import dependence⁵ then exposes regional industrialisers to the structural problem of outward dependency – the possibility that extra-regional suppliers will manipulate lines of supply to their perceived strategic advantage.

⁵ For pertinent comparative figures about import dependency in raw materials, see Raymond Vernon, *Two hungry giants: the United States and Japan in the quest for oil and ores*, Harvard University Press, Cambridge MA, 1983, Table A.1, p. 131.

Over both the long and the short terms, the drift into WW2 gets very close to a laboratory proof of these bald propositions. Japan's pursuit of an inner empire in Northern China, with options for future extension into Mongolia or West Siberia, was meant in large part to relieve these very kinds of resource pressures – and had it persisted, might actually have done so.⁶ But the US, despite progressive refinements of its own strategy of neutrality, set the clock on military action ticking by implementing, perhaps inadvertently, a *de facto* embargo on US oil exports to Japan.⁷ When the Japanese proceeded to shrug off this straitjacket, the carrier attack on Pearl Harbour was, like the later carrier attack on Darwin, essentially a perimeter defence of their most vital strategic objective, the capture of oilfields in the Dutch East Indies. Which, in the emerging circumstances, proved somewhat underwhelming⁸ – but was nonetheless better than the actually existing alternative of starvation on an American timetable.

After WW2, the big American vision was to convert international trade from a mechanism expressing strategic vulnerabilities into an instrument of the peace. But resource trade was given no systematic attention in this worthy multilateral project. There were, almost invariably, profoundly interesting early thoughts about the means for stabilizing raw materials markets by Lord Keynes, chief British negotiator of the new multilateral system, but they were overtaken at the time by more pressing financial matters and then by Keynes' untimely death.⁹ A radically diminished version of Keynes' approach nonetheless ended up as Chapter Six of the Havana Charter for the International Trade Organization (ITO) – only for that Charter to languish at

⁶ Notwithstanding some useful raw materials supplies, Manchukuo was basically a disappointment to the Japanese in this respect. It was not destined to be anywhere near such a let-down to the Chinese Communist Party that succeeded it. In 1959, the Daqing oil field was discovered slap bang in the middle of the former puppet state, a field that today ranks amongst the world's most significant oil discoveries.

⁷ For the makings of this argument about American inadvertence, see Daniel Moran, 'The battlefield and the marketplace: Two cautionary tales', in D. Moran & J.A. Russell (eds.), *Energy Security and Global Politics: The militarization of resource management*, Routledge, London, 2009, pp. 27-33.

⁸ Despite a substantial rise in Japanese imports of crude and refined oil from Dutch fields, their total imports of these commodities during WW2 never got near fifty per cent of their 1940 peak; for figures, see I. Beer & M. Foot (eds.), *The Oxford Companion to World War II*, Oxford University Press, Oxford, 1995, p. 1061.

⁹ See John Maynard Keynes, 'The International Control of Raw Materials', *Journal of International Economics*, 4(3), 1974.

the doorstep of the US Congress.¹⁰ That diminished approach was then passed on down the line to the GATT, and so International Commodity Agreements for sugar, tin, wheat and coffee were created in the 1950s. But these individual agreements all existed in not-so-splendid isolation from each other, not enjoying any of the financial benefits of aggregation that Keynes envisaged for effective commodity control. Furthermore, they derived no further sustenance from the GATT, which after 1955 concentrated its institutional energies for trade liberalization on industrial goods. In this vacuum of neglect, Keynes' worst fear – chronic restriction of output by commodity producers – eventually came to distinguish the oil market, the single most important commodity by the proverbial country mile. And in our time, high levels of supply-side concentration in iron ore trade, most likely the second most important traded commodity when prices are high, cause regular nightmares for Chinese authorities.

In theatres other than Asia, regional approaches sometimes yielded more positive strategic consequences for raw materials trade. Since a great deal of raw material trade, including in iron ore, was regarded as regional rather than international,¹¹ there was an open invitation. And so, in Europe, where *blitzkrieg* had been designed to counter the traditional Royal Navy belief that resource-poor Germany could always be embargoed and starved out, the European Iron and Steel Community, later followed by Euratom and the Common Agricultural Policy, basically put these powerful and overlapping themes from the first half of the twentieth century to rest. But no reassurance along those lines was ever developed in Asia, where the genetic code of regional security architecture was bilateral rather than regional. Here, 'institutional deficits' and 'organizational gaps' still continue to become progressively more important as you move from the periphery to the core of the regional system.¹² Not surprisingly, therefore, the potential manipulation of China's

¹⁰ For an early but durable analysis of this failure, see William Diebold, Jr., 'The End of the ITO', *Princeton Essays in International Finance*, 16, 1952.

¹¹ Note, for instance, how J.W.F. Rowe, in his 1965 book, classified iron ore as a regionally traded commodity – thereby excluding it from his study of international trade: see J.W.F. Rowe, *Primary commodities in international trade*, Cambridge University Press, London, 1965, pp. 3-4 and 28-29.

¹² See Kent Calder and Min Ye, 'Regionalism and Critical Junctures: Explaining the "Organization Gap" in Northeast Asia', *Journal of Northeast Asian Studies*, 4(2), 2004.

outward dependency problem now lurks in the penumbra of the sketchy air sea battle concept.¹³

Within this heavily bilateralised field of forces, it fell to the Japanese to organise their own relief from their problem of outward dependency with raw materials. And Australia, with an established trading position in coking coal and an emerging one in iron ore, was the obvious centre of their initial attentions. Long memories caused new civilian governments in Tokyo to recall Canberra's infamous trade diversion episode of 1936 and also the iron ore embargo of 1938, 'incidents' where Japan was on the receiving end of Australian-made discrimination.¹⁴ Consequently, on the cusp of the rise of the resources trade that would feed their reconstructed steel industry, Japanese authorities initiated commercial talks with Canberra that drew attention to the principle of equality of treatment in trade, the foundational principle of the GATT trade system. These talks commenced at a time when wheat and agricultural commodities were the backbone of Australia's exports to Japan. But the thin edge of a multilateral normative wedge was nonetheless delicately inserted into Australian trade policy by the 1957 Treaty on Commerce,¹⁵ and later complemented in relation to matters of foreign investment by the 1976 NARA treaty (which did many other things besides).¹⁶ When, therefore, resource trade volumes between Australia and Japan exploded, then so, too, did the strength and importance of that wedge of multilateral principles. Hence, in a most unlikely manner and from a totally unexpected corner, began the rise and rise again of the policy attachment of Australian governments to commercial multilateralism, an orientation now routinely regarded as Australia's 'first-best' policy choice in trade affairs.

¹³ For some discussion, see Liao Kai, 'The Australian factor in the United States' Western Pacific strategy', *Air & Space Power Journal*, 26(2), 2012.

¹⁴ On these two episodes, see, in chronological order, David Sissons, 'Manchester v. Japan: the Imperial Background of the Australian Trade Diversion Dispute with Japan, 1936', *Australian Outlook*, 30(3), 1976, and Kosmas Tsokhas, "'Trouble Must Follow": Australia's Ban on Iron Ore Exports to Japan in 1938', *Modern Asian Studies*, 29(4), 1995.

¹⁵ For a full explication of the talks and their relevant background, see Roderic Pitty, 'The Postwar Expansion of Trade with East Asia', in D. Goldsworthy (ed.), *Facing North: A Century of Australian Engagement with Asia, Volume 1, 1901 to the 1970s*, Melbourne University Press, Carlton South, 2001.

¹⁶ For a rare and recent assessment of the much-neglected NARA Treaty, see the special issue of the *Australian Journal of International Affairs*, 60(4), 2006 commissioned for the Treaty's thirtieth anniversary.

But norms alone were not sufficient to define exactly how these new markets would be instituted as day-to-day practice. At this lower level of abstraction, two things were clear; that the GATT offered no protections at all; and that the North American practice of vertical integration in steel was unacceptable in both Japan and Australia. In Japan, post-war governments sought high speed growth and wanted, therefore, to maximize the rate of reinvestment in domestic industry – and to this end, they virtually prohibited the overseas investment of Japanese capital at this stage. In Australia, this same conclusion was reached by more obtuse reasoning – namely, that Australians would not be willing to live with high levels of inward Japanese foreign investment in their emerging resource industries. Given these different but convergent exclusions, greatness came to be thrust upon the long-term contract as the institutional backbone for the emerging resource trade. Multi-year commitments to purchase were rolled out for the initial Hammersley project and quickly extended across the three other licensed projects in the Pilbara.¹⁷ The long duration of these opening contracts (between ten and sixteen years) proved critical in allowing local miners to raise their development costs through debt financing with domestic and/or international banks. A third way was therefore charted around the politically risky shoals of GATT-style free markets and vertical integration.

In quick order, the high quality of raw material inputs plus sharply falling prices for landed iron ore proved to be an important part of the profitability of Japan's reconstituted steelmakers.¹⁸ And behind the new contract pricing system stood the fearsome political power of Japan's steel cartel. In the beginning, it had a primary interest in ensuring that Australian suppliers got up and running; hence the initial contacts fixed both annual tonnages (with a ten per cent range for annual adjustments)

¹⁷ For details of the initial moves, see Gordon Boyce, 'Multilateral contracting in Australian mining: the development of Hamersley Iron, 1961 – 1966', *Enterprise & Society*, 2(3), 2001.

¹⁸ For an examination of the degree of this significance, see Krishna Mohan and Marvin Berkowitz, 'Raw Material Procurement Strategy: The Differential Advantage in the Success of Japanese Steel', *Journal of Purchasing and Materials Management*, 24(1), 1988. Prices of iron ore, it should be noted, fell from over US\$150 per ton in the early 1950s towards US\$50 per ton as the Pilbara geared up.

and prices (within a seven and a half per cent margin of variation).¹⁹ But it was also clear where the whip hand lay, for the Australian miners involved in negotiating those margins found themselves repeatedly dealing with the very same Japanese bureaucrat who spoke for his country's steel industry as a whole.²⁰ By the time that the first round of contracts had run their course, Japan's interests in iron ore supplies were shifting to Brazil where, in spite of higher transport costs, possibilities for broadening the market were now more seductive than the absolute level of prices.²¹ The contract periods available to established Australian mines therefore reduced to one year – so creating the benchmark pricing system that has been, until recently, regarded as the norm for the industry.

As every Lennonist knows, life is what happens while you're busy making other plans. While all this was going on, Australians generally liked to think of themselves as 'a small, rich industrial country', as Heinz Arndt so appropriately titled his 1968 book. As he saw it, there was a danger of exaggerating the possibility of Australia's reversion to a colonial division of labour; Australia's trade would, over the long run, consist increasingly of the exchange of manufactures.²² Forty years later, with Arndt's long run well and truly upon us, the sequenced industrial rise of Japan, the 'tiger economies' and China have all propelling the volume of resource sector exports upwards – making Australia (measured by trade integration) more Asian than any actual Asian country by the mid-1970s,²³ but also making manufactures progressively less important than bulk commodity exports in the balance of trade.²⁴ Meanwhile, Australian governments, working on Arndt-like defaults, struggle to

¹⁹ See Ben Smith, *The Japanese Connection: Negotiating a two-way street...*, in P. Hastings & A. Farran (eds.), *Australia's Resources Future: Threats, Myths and Realities in the 1980s*, Nelson in Association with the Australian Institute of International Affairs, West Melbourne, 1978, p. 117.

²⁰ On this, see Elizabeth Sexton, 'Katsushige Tanaka', *Australian Financial Review*, 22 June 1993.

²¹ Michael Byrnes, *Australia and the Asia Game*, Allen & Unwin, Sydney, 1994, p. 91.

²² Heinz W. Arndt, 'Australia and Japan: Trade Partners', *Three Banks Review*, 68, 1965, pp. 15-17.

²³ For my fuller argument about this, see Richard Leaver, 'Australia in Asia', in J. Goodman (ed.), *Regionalization, marketization and political change on the Pacific Rim*, Universidad de Guadalajara and UTS, Guadalajara and Sydney, 2006, pp. 117-119.

²⁴ For figures on the surge in resource exports, see Ellis Connolly and David Orsmond, 'The Mining Industry: From Bust to Boom', *Research Discussion Paper 2011-08*, Reserve Bank of Australia, December 2011, Table 3, p. 12, at <<http://www.rba.gov.au/publications/rdp/index.html>>.

develop a framework for public policy that is founded on the unexpected reality of a increasingly 'vertical' pattern of international trade.

What goes up...

It is important to separate out the quantitative and qualitative aspects of the up-phase of the China boom.²⁵ Quantitatively, the boom simply has no precedent: in the whole history of world steel, even including wartime experience, there is no instance where national production has increased six-fold in just over a decade. This has been phenomenally good news for Pilbara-based ore producers with high quality output and relative proximity on their side. Both prices and volumes of Australian exports took off, wrenching iron ore from three per cent of national exports at the beginning of the new millennium to a peak around seventeen per cent in a decade.²⁶ Along the way, with the aid of Beijing's February 2009 fiscal stimulus, expanding bulk commodity exports saved Australia from a second quarter of 'negative growth', the official definition of recession.

At the same time, there has been a pronounced qualitative degeneration of the marketplace. China may be the last of the planned economies, but compared to Japan, its steel industry is highly de-centred with provincial-level players dominant. The rise of this de-centred giant therefore brought with it a dramatic shift in bargaining power in favour of ore suppliers who were able to exact some dramatic price rises through the benchmark pricing system – more than seventy per cent in 2005, for instance, followed by nearly eighty per cent three years later. In addition, some five hundred firms were at the peak registered to import iron ore into China, creating a profitable domestic opportunity for arbitrage gambits between benchmark and contract supplies.²⁷

²⁵ In this respect, I follow my earlier analysis in Richard Leaver, 'Long Distance Trade in Iron Ore: Institutionalisation, De-institutionalisation and Market Stability', *Working Paper* no. 28, New Approaches to Building Markets in Asia Working Paper Series, Lee Kuan Yew School of Public Policy, National University of Singapore, 2011, <<http://www.caglkyschool.com/content/new-approaches-building-markets-asia-working-paper-series>>.

²⁶ Again, see Connolly and Orsmond, 'The Mining Industry...', Table 3.

²⁷ This was, of course, the lucrative game that attracted Rio Tinto's Stern Hu and his Shanghai-based price negotiating team. For an analysis, see Richard Leaver, 'Same Bed, Different Nightmares: The

But most important of all, the quantitative rise of 'disorganised China' brought on the decay of the benchmark pricing system – in large part because it was too difficult to decide who would speak for China's steel industry as a whole at the negotiating table. Consequently, in 2010, after a full year of inconclusive negotiations, BHP Billiton simply pronounced the benchmark system dead, and that it would forthwith sell ore through a combination of quarterly contracts and spot sales. The two other major iron ore exporters, both with bigger iron ore output than BHP, more or less fell in line with the new policy from Collins Street – which in any case soon morphed into a first preference for spot sales, a policy long favoured by BHP Billiton's current management team for all of its commodities. Spot prices therefore led the way up from the mid-2009 trough, eventually touching US\$180 per tonne at the beginning of the last quarter in 2011.

...must come down

Having ignored the profile of the upside for so long, it is now the more worrying shape of the downside that demands attention. According to industry optimists, even a China with slower growth and a lower price structure for iron ore will continue to deliver substantial Australian interests as steel production continues to approach a ceiling around a billion tons per annum.²⁸ Low production and transport costs situate Australia's established exporters at the very bottom of the cost curve – with low grade domestic ore production in China near the top.²⁹ Regardless of Chinese market expansion, lower prices will initially force these high cost domestic ore producers to the wall, thereby expanding the market share for imports of high grade ore.

Iron Ore War and Australia-China Relations', paper presented at the 18th Asian Studies Association of Australasia conference, Adelaide, July 2010, at <<http://asaa.asn.au/ASAA2010/index.php#l>>.

²⁸ The optimistic projections of the Australian industry even at the trough of the recent slump in ore prices are well summarised in Tony Boyd, 'Bucketload of queries for Fortescue', *Australian Financial Review*, 19 September 2012. On the other hand, even congenital optimists would not have expected the low growth scenario most recently predicted by the World Steel Association: a decline of Chinese growth of steel consumption to 2.5 per cent this year, with growth less than the global average next year; see James Crabtree and Javier Blas, 'Steel demand to slow over next two years', *Financial Times*, 11 October 2012.

²⁹ For one drawing of the cost curve, see Jason Murphy and Ayesha de Kretser, 'Tricky times for miners', *Australian Financial Review*, 8 – 9 September 2012.

This is a classic textbook argument which, for all that, does not deserved to be dismissed lightly; indeed, reports suggest that recent iron ore price falls have already closed forty per cent of China's mines,³⁰ with a consequent bounce of prices. But the argument ignores what might become crucial over the medium term – the spatial dimensions of lower and more domestically oriented growth in China. China's boom phase strongly favoured steel mills close to the coast, and their raw material needs were most readily served by imports of high grade materials brought in cheaply on bulk carriers. Greater domestic orientation to growth will progressively favour inland mills towards the west, mills whose raw materials needs are more likely to be serviced by domestically produced ores. The critical variable, in both phases of steel industry growth, has been and remains the high cost of inland rail transport. China has a technically excellent rail system which nonetheless labours in the face of the immense demands placed upon it by a huge population base.³¹ High rail freight costs contributed a good part of the reason why domestic Chinese iron ore was positioned at the top end of the cost curve in spite of ultra-low labour costs. But with inland mills servicing a rising proportion of future Chinese demand for steel, those high freight costs will be levied against imported ores – and removed from domestic ores.

A double-whammy of this kind is therefore likely to cut seaborne imports of iron ore off from inland mills, leading to lower Chinese import dependency on the one hand and downward pressure on internationally traded price structures on the other – two objectives favoured by Beijing. Add to this another body-blow – the build-up of perhaps twenty five per cent over-capacity in Chinese steel, and the need to work this off through structural adjustment – and there are the makings of serious backwash effects into the domestic Australian economy through declining terms of trade. Recent contingency planning for a possible election before the next federal budget suggests the Gillard government can see no good economic news coming

³⁰ See Leslie Hook, 'Chinese iron mines shut amid price fall', *Financial Times*, 27 September 2012, and also Matthew Stevens, 'Rio proclaims market victory', *Australian Financial Review*, 11 October 2012.

³¹ For a summary assessment of the present state of China's rail transport, see Anthony Beresford, Stephen Pettit and Yukuan Liu, 'Multimodal supply chains: iron ore from Australia to China', *Supply Chain Management*, 16(1), 2011, esp. pp. 34-5 and 39-40.

down the pipeline.³² Since world trade growth is now zero, and the IMF is predicting no great economic recovery before 2018, a synchronous downturn appears more likely than an upturn.

Moving forward, something resembling the lean years of the early 1980s is already being talked about by analysts with hindsight.³³ That period furnishes a radically different structural setting which contrasts sharply with the downturns of recent decades, when a combination of Chinese growth and Australian dollar devaluation helped cushion the local economy. Then, as now, Australia was part of a Pacific triangle, with Japan generating primary demand for Australian commodities. Then, as now, the Asian miracle performer faced intense US demands to raise its exchange rate and take pressure off American manufacturing. Then, as now, Australia's commodity markets had peaked before the recession started. But receipts for bulk exports continued to decline through the mid-1980s even after global recovery had set in – with the final downward push to the terms of trade provided by the Japanese accession to US pressure for Yen revaluation. The result was the legendary (but now forgotten) lecturing of the Australian public by treasurer Keating about the dangers of becoming a banana republic³⁴ – dangers that again loom on the horizon.

The shadow of an even more distant past – namely, the 1930s – provided Rudd's Treasury with a sound basis for policy guidance in 2009. But a contemporaneous 'lesson' from that same era – namely, that a high reliance on commodity exports paves the road to the sucker's pay-off – has slipped completely out of Canberra's official memory bank. While the drift to higher proportions of spot market sales for Australia's commodities kept delivering greater revenues when the market was rising, the nation has already seen how the spot market will lead prices down once the tide turns. BHP, the pace-setter on price frameworks on the way up,

³² For some of the plausible speculation about this, see Niki Savva, 'Can Labor spin its way to a March poll?', *The Australian*, 2 October 2012.

³³ For the views of Ross Garnaut along these lines, see Jacob Greber, 'Garnaut demands restraint for dog days ahead', *Australian Financial Review*, 2 October 2010.

³⁴ For a transcript of the Keating lecture, delivered over public radio from a telephone in the kitchen of a Sydney restaurant, see *Australian Financial Review*, 'The Federal Treasurer Speaks Out: The Interview That Shook The Market', 15 May 1986.

has been quick to begin looking for safety in contracts once it detected the shifting of the wind.³⁵ But Canberra and its dress circle of advisors has nonetheless held to its hands-off policy in the minerals domain – while occasionally looking frantically for ways and means to engage constructively with Beijing.³⁶

Visions of dialogue: means and ends

During what proved to be the closing phase of the Rudd government, Carl Ungerer and I argued that the Australian government should follow the lead set by American diplomacy and establish a Strategic Economic Dialogue with Beijing with the ultimate aim of producing an International Commodity Agreement (ICA) in iron ore.³⁷ A year later, Peter Drysdale, one of APEC's designers and a substantial influence in the drafting of Ken Henry's white paper, called for a treaty-oriented dialogue to cap the tensions arising out of Chinese direct investment in Australian minerals.³⁸ And a further year on, the Lowy Institute's new East Asian Programme director, Linda Jakobson, advocated a multi-faceted dialogue with political, defence and economic strands.³⁹ By this stage the Gillard government, with trade minister Craig Emerson in the lead, was beginning to engage with Beijing over an emerging issue that would, it hoped, help tie up loose ends – namely, the enhancement of China's food security through foreign investment in Australian agriculture, leading on to the completion of the seemingly moribund Australia-China Free Trade Agreement.⁴⁰ So just about everyone, it seems, now endorses the importance of

³⁵ See Ayesha De Kretser, 'BHP happy to stick with monthly ore pricing', *Australian Financial Review*, 4 October 2011.

³⁶ When, for instance, the Rudd government proposed its Resource Super Profits Tax, concerns in Beijing led trade minister Simon Crean to convene what was called 'a high-level economic dialogue' to help contain any damage; see Michael Sainsbury, 'Crean bid to calm China leaders', [The Australian](#), 18 May 2010. According to this report, it was the fourth such 'high-level dialogue' – but if so, then the previous three have completely disappeared without trace.

³⁷ Richard Leaver and Carl Ungerer, 'A natural power: Challenges for Australia's resources diplomacy in Asia', *Strategy Report*, Australian Strategic Policy Institute, Canberra, May 2010, pp. 22-23.

³⁸ For reportage and some discussion, see Adrian Rollins, 'APEC architect calls for friendship treaty with Beijing', *Australian Financial Review*, 13 July 2011; Greg Earl, 'A lesson on bilateral ties from the Whitlam era', *Australian Financial Review*, 14 July 2011, and Peter Drysdale, 'Next step forward in China relationship', *Australian Financial Review*, 16 July 2011.

³⁹ Linda Jakobson, 'Australia-China Ties: In Search of Political Trust', *Policy Brief*, Lowy Institute for International Policy, June 2012.

⁴⁰ Angus Grigg and Lisa Murray, 'Labor's China foodbowl plan', *Australian Financial Review*, 31 May 2012.

dialogue with China – while having somewhat different visions about the ultimate objective it should serve. A few comments on some of these differences about the ends of dialogue therefore provides the apposite note for wrapping up this paper.

Let's start with Drysdale's ideas. It is increasingly obvious that he regards the whole post-war history of Japan-Australia commercial relations as a 'template'⁴¹ for what an Australian government should now do with the emerging nations of the region, including China. But in relation to iron ore, the 'Japan template' was always imperfect in two specific senses: it served short-term Japanese commercial interests much more than Australian ones; and over the long term, it did not create a stable foundation (in the sense that long-term contracts yielded to annual contracts before yielding to the current mix of quarterly contracts and spot sales). Drysdale himself implicitly acknowledges serious flaws in the template in that it hasn't yet been able to close out Canberra's hoped-for FTA deal with Tokyo – a flaw for which he can largely point the finger at the low quality agricultural deal done with Washington under the AUSFTA. This suggests a more general, more powerful imperfection with the template – namely, that Japan and Australia, as America's 'odd men out' in Asia, can't expect their direct transactions to travel very far inside the region.

The argument of Emerson and others for shifting the ground for future dialogue to Chinese investment in greenfields Australian agriculture is fraught with potential dangers. This new point of focus would keep dialogue at a safe distance from the minerals trade that is, and will remain, the backbone of Australia's China exports. But it can't be taken for granted that Canberra will emerge victorious over the Queensland Nationals on the rights and wrongs of what they regard as 'selling off the farm' (and least of all under a Coalition government). But even if it can, the huge size of the minerals trade relative to likely agricultural trade will remain, and talking about the latter in the hope of not noticing the former risks fooling yourself that something meaningful is being accomplished. Adding ballast is well and fine, but adding only small amounts of it lacks effect.

⁴¹ As quoted in *The Australian*, 'Free trade deal with Japan 'urgent'', 8 October 2012.

Finally, something approaching Jakobson's counsel appears to have been taken up by foreign minister Bob Carr, who recently announced that DFAT's Head had 'recently' been to Beijing to discuss a 'more formal and prescribed' leadership meeting at the ministerial and official level.⁴² No Chinese response has yet been forthcoming – and most likely will not be during what is now becoming the closing phase of the first Gillard government; what emerges after it (either a second Gillard government or a Coalition government) will at least provide a modicum of continuity for Chinese considerations. But no more than a modicum, for the fact that both of those future Australian governments are already committed to more White Papers suggests good reasons for further Chinese caution. As with the Americans and APEC twenty years ago, the chances are that ministers and officials will never be quite senior enough to capture full leadership attentions in Beijing. Meanwhile, Australians would not want something more high-powered for fear of being perceived as gaming the AUSMIN process.

While no process of dialogue provides a silver bullet, a dialogue over an iron ore ICA has considerable advantages over any of the above. First, it goes to the heart of a very real Chinese interest in a contractually arranged pricing system; Beijing never endorsed BHP's 2010 abandonment of price negotiations, but neither was it willing to cut off its nose to spite its face by refusing to purchase imported ore, an action which would have shut down its steel industry. Second, an effective ICA could never be just a bilateral undertaking; Brazil is too big a supplier to ignore, and they would have to be brought in, best from the beginning. And that would go a long way to addressing Beijing's most scary iron ore nightmare, the possibility of exclusive producer cooperation along the lines of OPEC. So, by holding cards that Beijing would like to see out of the game, Canberra has a very strong hand in this context compared to any other. Its own hurdle is whether it is willing to let go of the belief that what is good for BHP is good for Australia. But perhaps a modicum of creative destruction along the downslope of the commodities super-cycle will aid that letting go process.

⁴² See Sky News Australia, interview with Bob Carr by Peter Van Onselen and Greg Sheridan, 7 October 2012, <http://foreignminister.gov.au/transcripts/2012/bc_tr_121010_sky_news.html>.